

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Ortiz Analyst: LuAnna Hass Bill Number: SB 853  
Related Bills: See Legislative History Telephone: 845-7478 Introduced Date: 02-23-01  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Interest Deduction on Utility Company Financed Indebtedness

### SUMMARY

This bill would allow a deduction for interest paid on a loan financed through a utility company to purchase energy efficient equipment and products for California residences.

### PURPOSE OF THE BILL

It appears the purpose of this bill is to encourage energy conservation by providing an incentive to taxpayers to make energy efficient improvements.

### EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. It would apply to taxable years beginning on or after January 1, 2001.

### POSITION

Pending.

### Summary of Suggested Amendments

Amendment 1 would resolve the department's technical concern regarding an undefined phrase.

### ANALYSIS

#### FEDERAL/STATE LAW

Federal law currently provides two energy-related credits: an energy credit that is one portion of the investment credit and a business credit for the production of electricity from certain renewable resources.

The energy investment credit is equal to 10% of the basis of energy property placed in service during the taxable year. Energy property includes equipment that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat. It also includes equipment that produces, distributes, or uses energy derived from geothermal deposits. The equipment also must meet performance and quality standards prescribed by federal regulations.

Board Position:	Department Director	Date
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The business credit for the production of electricity from certain renewable resources is equal to 1.5 cents multiplied by the kilowatt hours of electricity produced by the taxpayer from qualified energy resources at a qualified facility. To qualify for the credit the electricity is required to be sold to an unrelated person during the taxable year. Qualified energy resources include wind, closed-loop biomass, and poultry waste.

Under federal and state law, gross income includes all income from whatever source derived, including compensation, business income, gains from property, dividends, rents, interest, and royalties, unless it is specifically exempt. Certain types of income are excluded from gross income, such as amounts received from gifts and inheritances, compensation for injuries and sickness, qualified scholarships, educational assistance programs, and foster care payments. In addition, an exclusion from gross income is allowed for the value of any subsidy that is provided either directly or indirectly by a public utility to a taxpayer for the purchase or installation of any "energy conservation measure." Any measure that is primarily designed to reduce the consumption of electricity or natural gas, or improve the energy management within a house, apartment, condominium, mobile home, boat, or other similar property is considered an "energy conservation measure."

Existing federal and state laws allow for the deduction of certain expenses when calculating adjusted gross income (AGI), such as trade and business expenses, losses from sale or exchange of property, contributions for pension, profit-sharing and annuity plans of self employed individuals, retirement savings, and alimony. Thus, all taxpayers with this type of expense receive the benefit of the deduction, regardless of whether these deductions were itemized or the standard deduction was claimed. This is known as an "above-the-line" deduction. Federal and state law also allows deductions for moving expenses and interest on education loans when calculating AGI.

Existing federal and state law allows individuals to deduct certain expenses, such as medical expenses, charitable contributions, certain interest, and taxes, as itemized deductions. Certain miscellaneous itemized deductions (excluding home mortgage interest) are limited and may be claimed only to the extent that they exceed 2% of the taxpayer's AGI.

Generally, 100% of home mortgage interest may be taken as an itemized deduction for federal and state purposes. Qualified home mortgage interest is limited to interest paid or accrued by the taxpayer during the taxable year on acquisition indebtedness (acquisition loan) or home equity indebtedness (home equity loan). An acquisition loan is the financing to acquire, construct, or substantially improve the taxpayer's principal residence. A home equity loan is any financing, other than the original acquisition loan, that is not more than the fair market value of the residence less the original acquisition loan. The amount that can be treated as home equity indebtedness cannot exceed \$100,000. The qualified residence must secure both the acquisition loan and/or home equity loan. However, a debt will not be considered to be secured by a qualified residence if it is secured solely by a security interest, such as a mechanic's lien or judgment lien, that attaches to the property without the consent of the debtor.

State law defines a public utility to include electrical corporations, which is any corporation or person that owns, controls, operates, or manages any electrical plant for compensation within California. The department has interpreted this definition to include all public utility companies, privately owned public utility companies, and municipal utility districts as defined under the Municipal Utility District Act.

### THIS BILL

This bill would allow an individual an above-the-line deduction for interest paid or incurred on a utility company financed loan that is used to purchase and install energy efficient equipment or products as part of a qualified residence in California. This bill defines “energy efficient equipment” as products and equipment that meet specifications established by a utility company for their loan program.

This bill also provides additional definitions for key terms that would be used in implementing this deduction.

This bill also provides a statement of legislative intent that would encourage utility companies to provide written notification to their customers that the interest paid or incurred on the loan is deductible for state income tax purposes on their tax returns.

### IMPLEMENTATION CONSIDERATIONS

Implementation of this bill would not significantly impact the department's programs and operations.

### TECHNICAL CONSIDERATIONS

This bill uses the phrase “qualified energy efficiency interest” to describe a type of interest paid by a taxpayer. Amendment 1 is provided to delete this phrase, as it is unnecessary in this bill.

The encouragement that utility companies notify their customers of the ability to deduct the interest on a loan financed through the utility company on their tax return may be more appropriately located in the Public Utilities Code.

### **PROGRAM BACKGROUND**

Several public utility companies and municipalities have programs to finance the purchase of energy efficient products or equipment. Eligible equipment can include heating and air-conditioning systems, attic and wall insulation, solar domestic water heating systems, and high performance windows. Some utility companies will normally record a fixture filing (UCC1 Financing Statement) with the county recorder as collateral for the loan.

### **OTHER STATES’ INFORMATION**

Although no other state currently allows an interest deduction for utility company loans used to acquire and install energy conservation equipment on personal residences, many states do have various income tax incentives in the form of credits to encourage energy efficiency and conservation.

### **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

## **ECONOMIC IMPACT**

### Tax Revenue Estimate

Based on data and assumptions discussed below, it is projected this bill would result in revenue losses under the Personal Income Tax Law in the \$1 million-\$2 million range annually beginning in 2002-2003.

### Tax Revenue Discussion

The revenue impact of this bill would be determined by the amount of interest paid on utility company loans incurred for energy efficient products or equipment and not currently deducted, and the marginal tax rates of taxpayers incurring such loans.

Only one significant municipal utility district in California was identified as lending money to its customers to encourage and enable customers to acquire and install energy efficient products or equipment on a qualified residence. According to staff at this municipal utility district, outstanding loans currently total roughly \$70 million. Each year, some level of new loans is funded and a certain level of existing loans is paid off. Once funded, borrowers generally repay loans, on average, over a period of 48 months. This utility district currently offers fixed interest rates that vary according to the amount of the loan. The overall average interest rate is estimated at 9.5%. Assuming an average marginal tax rate of 6% for taxpayers who borrow, revenue losses under current conditions would range from between \$500,000 and \$1 million annually. If, however, due to the enactment of the proposed deduction, other utilities initiated similar loan programs, revenue losses potentially would increase in subsequent years.

## **ARGUMENTS/POLICY CONCERNS**

This bill would establish an above-the-line deduction for which federal law has no counterpart, thus increasing nonconformity and the complexity of California tax return preparation.

To the extent interest on utility company financed indebtedness is considered qualified residence interest, it is currently deductible as an itemized deduction.

## **LEGISLATIVE STAFF CONTACT**

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 853  
As Introduced February 23, 2001

AMENDMENT 1

On page 2, line 12, strikeout "qualified energy efficiency"